

**MINUTES
REGULAR MEETING
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**Friday, October 20, 2006
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Dr. Keith Meredith, Chair of the ASRS Board, called the meeting to order at 8:37 a.m., MST.

The meeting was teleconferenced to the ASRS office at 7660 E. Broadway, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Dr. Keith Meredith, Chair
Mr. Michael Townsend, Vice Chair
Mr. David Byers
Mr. Jaime Gutierrez
Mr. Chris Harris
Mr. Karl Polen
Mr. Lawrence Trachtenberg (via teleconference)
Mr. Steven Zeman

Absent: Ms. Anne Mariucci

A quorum was present for the purpose of conducting business.

2. Approval of the Consent Agenda

Motion: Mr. Dave Byers moved to approve Refunds, Death Benefits and Retirements;

And

Approve the System Transfers;

And

Approve the minutes of the August 18, 2006, Regular Session of the ASRS Board;

And

Approve the Applications and Agreements with the Following Employers;

- City of Page
- Ha:San Ed. Services
- Prescott Valley Charter School
- Town of Star Valley

And

Approve the Representative Payeeship Request for Laura M. Nance.

Mr. Steve Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

3. Approval, Modification, or Rejection of Recommended Administrative Law Judge's Decision

Mr. Karl Polen stated that he would abstain from commenting or voting on the first appeal due to the fact that he had previously served on the Board of the Central Arizona Water Conservation District.

Mr. Tony Medina, Retiree, addressed the Board regarding his appeal. Mr. Medina expressed that he felt the error in his situation sits with his previous employer, Central Arizona Water Conservation District (CAP). Mr. Medina stated that because it was CAP that incorrectly calculated his time of employment, he should be able to buy back the time he was shorted. Dr. Meredith explained that because Mr. Medina was currently retired, state statute prohibited the Board from allowing him to buy back time. Dr. Meredith suggested that since CAP admitted to the error, perhaps Mr. Medina could find a solution with them.

Motion: Mr. Michael Townsend moved to accept the ruling of the Administrative Law Judge.

Mr. Chris Harris seconded the motion.

By a vote of 7 in favor, 0 opposed, 1 abstentions and 1 excused the motion was approved.

Mr. Tom McClory, Assistant Attorney General, addressed the Board regarding the appeal involving Mesa Public Schools. Mr. McClory stated that the Administrative Law Judge found in favor of Mesa Public Schools in that incentive pay received after the last day of employment should be considered compensation as it was earned during the time of employment.

Mr. Dave Byers asked if staff had fully considered the implications of this ruling. Mr. Anthony Guarino, Deputy Director and Chief Operations Officer, stated that the agency was capable of handling

such an adjustment in calculating an individual's benefit and that no negative service implications were foreseen.

Motion: Mr. Michael Townsend moved to accept the ruling of the Administrative Law Judge.

Mr. Jaime Gutierrez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions and 1 excused the motion was approved.

Motion: Mr. Dave Byers moved to direct staff to do an analysis of the implications of this decision and that if that analysis were to show any significant implications, staff shall make a motion for the Board to reconsider the issue at the December Board meeting.

Mr. Steve Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion passed.

4. Presentation, Discussion and Appropriate Action Regarding the Notice of Final Rulemaking for Article 5, Purchasing Service Credit

Ms. Nancy Johnson, Rules Coordinator, addressed the Board regarding the notice of final rulemaking for Article 5, Purchasing Service Credit. Ms. Johnson stated that A.R.S. §§ 38-743, 38-744, 38-745, and 38-747 allow a current, contributing member of the ASRS to purchase credited service, upon which the ASRS benefits are based. The current rules became effective June 30, 2005. Since that time, the ASRS has identified several areas in the Purchasing Service Credit rules that need adjustment in order for the program to conform to federal and state law, run more smoothly, and treat all members fairly.

The rulemaking will:

1. Increase the amount of time a member has to return a signed Irrevocable Payroll Deduction Authorization and provide the circumstances under which exceptions to the time limitations will be made.
2. Amend the document requirements for purchasing military service credit.
3. Clarify the difference between terminating and transferring employment.
4. Define additional terms.
5. Adjust various items of procedure in the process for purchasing service credit.
6. Make technical and clarifying changes to the rules.

An Oral Proceeding was held on these rules on October 3, 2006. There were no public comments. The content of the rules in the final rulemaking is the same as in the proposed rulemaking.

Motion: Mr. Jaime Gutierrez moved to renew the Notice of Final Rulemaking for Article 5, Purchasing Service Credit.

Mr. Steve Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding the Notice of Final Rulemaking for Article 7, Contributions Not Withheld

Ms. Nancy Johnson, Rules Coordinator, addressed the Board regarding the notice of final rulemaking for Article 7, Contributions Not Withheld. Ms. Johnson stated that A.R.S. § 38-736 provides when member contributions are to begin. A.R.S. §§ 38-736 and 38-737 provide how employer and member contributions are paid, and A.R.S. § 38-738 identifies what happens if less than the correct amount of employer or member contributions are made. This rulemaking specifies how the ASRS handles claims that required contributions were not withheld, including the procedure for:

1. Notifying the ASRS that less than the correct amount of contributions may have been paid into the ASRS by an employer.
2. Determining whether less than the correct amount of contributions has been paid into the ASRS by an employer.
3. Determining the amount of contributions that shall be paid into the ASRS.
4. Disputing ASRS determinations involving contributions not withheld.
5. Specifying how the contributions shall be paid into the ASRS.

An Oral Proceeding was held on these rules on September 13, 2006. There were no public comments. The content of the rules in the final rulemaking is the same as in the proposed rulemaking.

Motion: Mr. Steve Zeman moved to approve the Notice of Final Rulemaking for Article 7, Contributions Not Withheld.

Mr. Jaime Gutierrez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

6. Presentation, Discussion and Appropriate Action Regarding the Current Asset Allocation As Well As Alternate Asset Allocations and Implications of Alternate Asset Allocations for the System

Mr. Charlie Chittenden, Actuary, presented information regarding potential changes to the current asset allocation for the System and implications of any such potential changes. As an update, Mr. Chittenden stated that several meetings had been held to discuss potential options for System members and several more meetings would be taking place over the next month. These meetings are meant to address any questions System members may have about staying in the System or potentially transferring to the Plan and the implications of both options.

Mr. Chittenden explained that if there were to be changes to the System Asset Allocation, these changes would attempt to minimize the chance of and the amount of potential benefit reductions. Mr. Chittenden presented several different possibilities to the Board.

7. Presentation, Discussion and Appropriate Action Regarding the System Valuation and the Allocation of Excess Surplus

Mr. Charlie Chittenden, Actuary, presented the System Valuation to the Board. Mr. Chittenden stated that in compliance with A.R.S. § 38-714 (H) (3), at the end of each fiscal year, the ASRS actuary performs a valuation of the System to determine its assets, liabilities and the funded status, and reports that information to the Board. The report submitted to the Board is the actuarial valuation for the year ended June 30, 2006. The report indicates that the liabilities were \$503.3 million, the assets are estimated at \$549.1 million and the funded status of the system is 109.09%.

Mr. Chittenden also suggested that the mortality table for the System be changed to a generational table for the June 30, 2007 valuation and all subsequent valuations. In a frozen program with an aging population, accurate mortality estimates are critical. The System has experienced mortality losses even after adopting the current 2005 table. A generational table anticipates future mortality improvements, and if a Generational Mortality Table had been used, the funded status of the System would have been 108.02%.

Mr. Chittenden addressed the allocation of excess surplus to System members and stated that R2-8-206 states "If the funded status is more than 105%, the Board shall exercise its discretion...to determine whether to allocate excess surplus to the appropriate System members and System members' beneficiaries. In determining whether to allocate excess surplus, the Board shall consider all factors that affect the funded status or may affect the funded status in the future."

The actuarial valuation for the year ended June 30, 2006, indicates that the funded status of the system is 109.09%.

If the Board were to allocate surplus, it could do so only insofar as the allocation reduced the funded status to 105%. Thus, the allocation would provide a small increase (about 4.09%) in member benefits and accounts.

Investment returns in fiscal year 2006 were 9.8%. If the return for 2007 is less than 8%, the System will have an investment loss, and such a loss will be fully reflected in the funded status as of June 30, 2007. If the funded status declines below 95%, the Board must reduce benefits, and if the funded status declines below 100%, there would be reliance on future investment earnings to be above 8%.

For these reasons, it is believed that maintaining the current level of benefits with a funded status of 109.09% is prudent.

Mr. Uwe Fink and Mr. Jim Burke, both System members, addressed the Board regarding changes to the System as mentioned in agenda item number six. They reported that among System members they have met with, the general consensus is that more time is needed to determine if any changes need to be made at this point. Some of the major concerns were that the "lump sum" or "cash out" option would be detrimental to members remaining in the System. Also, the issue of whether or not this is a real risk was raised. Mr. Fink stated that he believed expected investment returns should be able to provide for current benefit levels and no real risk existed that would cause benefits to be reduced. Mr. Fink also stated that he felt the real risk to system members would not present itself until 40 years down the road. As a final point, both Mr. Fink and Mr. Burke expressed that System members had already accepted the risks of choosing to be in the System.

Motion: Mr. Karl Polen moved to accept the System Valuation as presented

And

Moved to not allocate excess surplus at this time;

And

Moved to use a Generational Mortality Table for the System Valuation of June 30, 2007, and all subsequent valuations and instruct staff to amend R2-8-202 to include the Generational Mortality Table.

Mr. Dave Byers seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions and 1 excused, the motion passed.

8. Presentation, Discussion and Appropriate Action Regarding the ASRS Global Tactical Asset Allocation (GTAA) Asset Class Review

Mr. Gary Dokes, Chief Investment Officer, Mr. Dan Kapanak, Manager of Investment Analysis, and Mr. Terry Dennison, Principal, Mercer Investment Consulting, addressed the Board regarding the ASRS Global Tactical Asset Allocation (GTAA) Asset Class Review. Mr. Dokes stated that the ASRS GTAA program began in January 2004, and provides for the tactical investment among asset classes. Such tactical, active decisions are anticipated to provide incremental return relative to ASRS Total Fund Benchmark. As of September 30, 2006, the total market value of the ASRS GTAA asset class was \$2.6 billion, or approximately 10.6% of the ASRS Total Fund. The GTAA asset class policy target/range is 10% \pm 2%.

Mr. Kapanak stated that despite recent poor performance, both GTAA managers are expected to outperform over the long-term for several reasons: stable organizational structure, prudent asset growth strategies, top-quality investment professionals in portfolio management and research, ongoing commitment to research and model enhancement and consistently applied investment process. Mercer highly rates both GTAA manager products at A.

Mr. Dokes also stated that as the GTAA program is approaching the three year anniversary, IMD will continue to closely monitor both managers given performance is below expectations and constraints have recently been relaxed. IMD will also consider potential modifications to the program and evaluate other GTAA managers.

9. Presentation, Discussion and Appropriate Action Regarding the ASRS Real Estate Asset Class Review

Mr. Gary Dokes, Mr. Eric Rovelli, Real Estate Portfolio Manager, Ms. Micolyn Yalonis, Principal, The Townsend Group and Ms. Linda Assante, Principal, The Townsend Group, addressed the Board regarding the ASRS Real Estate Asset Review.

Mr. Rovelli went over highlights and developments since the second quarter of 2005: the real estate program represents 6% of the ASRS strategic asset allocation policy, the program invests in public and private, core and non-core U.S. and international institutional real estate markets; the Townsend Group was hired in March 2006 as the ASRS Real Estate Consultant and enhancements to the ASRS Real Estate Program were approved by the Board in May 2006; the ASRS Real Estate Program Implementation Plan was developed and this plan provides the road map for the real estate program for 2006 and the first quarter 2007.

10. Presentation, Discussion and Appropriate Action Regarding the ASRS Asset Allocation Study

Mr. Gary Dokes, Mr. Dan Kapanak and Mr. Allan Martin, Partner, New England Pension Consultants (NEPC), via phone, addressed the Board regarding the ASRS Asset Allocation Study. Mr. Dokes and Mr. Kapanak discussed the analysis completed by NEPC and proposals regarding the broad strategic asset allocation policy and portfolio construction and implementation.

The ASRS Asset Allocation Policy Schematic, which contains recommended changes, was presented to the Board (please see final page attachment).

Motion: Mr. Chris Harris moved to approve the ASRS Asset Allocation Policy Schematic which contains policy targets/ranges for the ASRS broad asset classes, investment strategies, passive/active and GTAA programs and benchmarks for the ASRS broad asset classes and Total Fund

And

Approve the ASRS Dynamic Asset Allocation approach, which initiates an asset allocation study based on market dynamics rather than set 3-year periodicity, and provides for the potential introduction of new asset classes on a periodic basis.

Mr. Larry Trachtenberg seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions and 1 excused, the motion passed.

11. Presentation, Discussion and Appropriate Action Regarding the Presentation of the GFOA Award

Mr. Michael Townsend, Chair, Operations Committee, reported to the Board that the ASRS received the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting for its June 30, 2005 Comprehensive Annual Financial Report (CAFR) and that this is the seventeenth year that the ASRS has received this prestigious award. A Certificate of Achievement is presented by the GFOA to those government units whose annual financial reports are judged to adhere to program standards and represents the highest award in government financial reporting.

Mr. Townsend stated that it takes many hours of hard work by the ASRS to produce the CAFR each year. The CAFR is intended to provide complete and reliable information for decision making, to insure compliance with legal requirements, and is a means of measuring the responsible stewardship of the assets of the ASRS.

Mr. Townsend presented the award to Ms. Nancy Linssen, Assistant Director, Financial Services Division, and Ms. Leslie De'Reche, Comptroller.

12. Director's Report

Mr. Matson had no comments.

13. Possible Presentation Regarding Board Committee Updates

Mr. Jaime Gutierrez, Vice-Chair, External Affairs Committee, had no comments.

Mr. Larry Trachtenberg, Chair, Investment Committee, had no comments.

Mr. Michael Townsend, Chair, Operations Committee, had no comments.

14. Board Requests for Agenda Items

There were no requests for future agenda items.

15. Call to the Public

No members of the public requested to speak.

16. The next ASRS Regular Board meeting is scheduled for Friday, November 17, at 8:30 a.m., at 3300 N. Central Avenue, 10th Floor Board room, Phoenix, Arizona.

17. Adjournment of the ASRS Board

Dr. Meredith adjourned the August 18, 2006 Board meeting at 11:43 a.m.

ARIZONA STATE RETIREMENT SYSTEM

Anne Schrode, Secretary

Date

Paul Matson, Director

Date

ASRS Asset Allocation Policy Schematic (Exhibit A)

		Current Policy	Actual Alloc. 9/22/2006	Proposed Policy			
Investment Category				Target	Range	Passive	Benchmark
Asset Classes	US Equity						
	Large Cap	43%	44%	31%	26 - 36%	65 ±10	S&P 500
	Mid Cap	5	6	7	5 - 9	45 ±20	S&P 400
	Small Cap	5	6	7	5 - 9	30 ±20	S&P 600
	Sub-Total	53	56	45	40 - 50		
	International Equity	15	18	18	13 - 20	10 ±5	MSCI ACWI ex. US
	US Fixed Income	26	25	26	21 - 31	55 ±20	Lehman Aggregate
	Real Estate	6	1	6	4 - 8	NA	NCREIF + 1%
	Private Equity	0	0	5	3 - 7	NA	Russell 3000 + 3%
	TOTAL	100	100	100			
Strategies within Asset Classes: Beta exposure with active risk	Opportunistic Asset Classes:	0	1.5	0	0 - 5	NA	Asset Class Specific (TBD)
	• Int'l Equity Small Cap	1.5	1.5	1.8	0 - 3.6	0	MSCI EAFE Small Cap
	Global TAA	10	10.5	10	8 - 12	NA	ASRS Total Fund Benchmark
Investment Strategies	Expected Return	8.02%	8.22%	8.30%			
	Standard Deviation	11.49%	12.03%	11.88%			
	Sharpe Ratio	0.37	0.37	0.38			
	Absolute Return Strategies	0	0	0	0 - 5	NA	> 0%
	(Assumes: Maximum 5% Allocation, Volatility 3% Relative to Cash, Return: Cash + 3%, IR of 1.0)						
	Expected Return			8.43%			
	Standard Deviation			11.96%			
	Sharpe Ratio			0.39			
	Total Fund Benchmark:	31% Large Cap (S&P 500), 7% Mid Cap (S&P 400), 7% Small Cap (S&P 600), 18% Intl Equity (ACWI xUS)					
		26% Fixed Income (Leh. Agg.), 6% Real Estate (NCREIF + 1%), 5% Private Equity (Russell 3000 + 3%)					
Red denotes changes from ASRS existing Asset Allocation Policy which was approved by the Board in August 2003							